

Cash flow statements: indirect method



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a) International Accounting Standard 7 (IAS 7) lays down the standards expected by companies when presenting information about changes in cash or cash equivalents. Under IAS 7, a company is required to present a statement of cash flow showing the changes in cash and cash equivalents from the three key areas of operating, investing and financing (Wheetman, 2006) ^[1] .

The definition of cash and cash equivalents includes cash, as well as any other investments that are considered high liquidity and can be easily converted into a known amount of cash. When presenting cash flow statements, there are two main ways that are recognised by IAS 7: direct and indirect, although a preference is shown for the direct method.

The direct method involves reporting the cash flow gross, as it happens, so that all cash out and all cash in are simply taken gross without any adjustments made for other factors.

On the other hand, the indirect method shows the net cash flows once all other factors have been taken into account. It is not necessary for companies to use the direct method and due to the costly process of looking through all receipts and expenses, it is much more common for companies to use the indirect method (Schwartz, 1996) ^[2] .

b) China World Limited (CWL), as is the case with many large companies, has opted to report its cash flow statements in an indirect way. The cash flow statement in the published accounts year ended 31st December 2007

reflects this choice fully; however, there is no discussion as to why the direct method was not used.

During the preparation of the accounts, CWL has made several assumptions in order to produce the cash flow statements. For example, depreciation is accounted for during the cash flow statement, as it is not a true expense. When the profit figure, which is the starting point for the cash flow statements, is calculated, the depreciation is taken into account based on the depreciation policies being followed by the company. In the case of CWL, the property owned by the company is depreciated over 20 years, fixtures and fittings over a range of 5 to 10 years and motor vehicles over a period of 5 years. As these amounts are merely policy choices and are done on a straight line method, the actual amount allocated to depreciation has no immediate bearing on the actual cash flow statement and is, therefore, added back on to the ultimate net profit figure during the indirect method calculation. A similar approach is taken with amortisation of intangible assets where the initial costs of these assets are spread across the expected life span of the asset. This is not an actual cash movement and is, therefore, added back on to the final profit figure during the cash flow statement (Mills, 1991) ^[3].

Additional adjustments are then made to include cash based transactions such as interest receivable in an attempt to show a truly accurate picture of cash flow movement. Changes in inventory levels are assumed to reflect the amount of cash available, directly. This is not necessarily the case and it is

merely an assumption that CWL has made for the benefit of the cash flow statement (Mills & Yanamura, 1998) ^[4] .

Other assumptions that have been made are likely to have an impact on the cash flow. For example, when calculating the net profits, there is an allowance made for bad debtors. This figure is purely an estimate based on previous experiences and the perceived risks associated with the various creditors that are related to the company at any time. In using the indirect method, these assumptions will still bear some relevance to the bottom line, meaning that a change of policy or assumption can have a direct impact on the way in which the cash flow statement looks (Barth, 2006) ^[5] .

As CWL has international operations, it has to deal with the currency fluctuations that occur throughout the year. As the consolidated accounts are presented in pounds sterling, cash values in local currency need to be converted at the exchange rate between the country in which the transaction occurs and British sterling. CWL takes the approach of averaging the exchange rate over the period in which the transactions took place. This assumption is necessary as it simply is not possible to take an accurate exchange rate at the exact point in which a transaction is undertaken. However, it does have a potentially misleading impact on the cash flow statement.

Appendix 1 contains a copy of CWL's accounts as they would appear, had the direct cash flow approach been taken.

c) The cash flow statement is merely one aspect of the financial analysis of the company's financial status. Although cash flow and the liquidity of the company is vital in the overall health of the company, it is not the only measure of success. Firstly, let us consider the liquidity of the liquidity position of CWL.

One of the most commonly used ratios is that of the liquidity ratio known as the current ratio. This shows the company's ability to meet its current liabilities with its current assets. For true financial health, a company wishes to see a ratio that is as high as possible, and at an absolute minimum at least 1: 1. In the case of CWL the ratio in 2007 was 1. 905, which in itself is particularly healthy and is even healthier when it is compared with the previous year's figure of 1. 734. This increase in the current ratio is primarily due to better management of the money owed by creditors to the company.

A further liquidity test is that of the acid test, which is similar in nature to the current ratio but shows a much starker picture as it looks at the ability of the company to meet its current liabilities purely by the use of cash or cash equivalents. In reality, this is a more realistic view of the company's liquidity position as its main aim is to be able to pay any liabilities that are imminently due, without the need to cash in any other assets, even if they are considered current. In analysing the acid ratio, it is possible to see a different picture of CWL. Although the current ratio shows a particularly healthy liquidity position, it is clear that much of the current assets of CWL are tied up in inventories or in receivables (Chirinko & Schaller, 1995) ^[6].

CWL should aim to manage receivables and inventories better in order to bring the quick ratio closer to the desirable 1: 1 position. Although the figure

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of 0. 508 falls considerably short of this ideal ratio, it is a vast improvement on the 2006 figure of 0. 383.

As well as liquidity the profitability of the company should be considered. This is the view of how well the company is using its assets to produce a suitable rate of return. The main profitability ratio is that of gross profit margin. As CWL is a manufacturing based company, it is expected that the figure will be at the lower end of the scale; however, the figure of 35. 95% is relatively healthy and shows a good rate of profit. Despite this, attention should be given to the cost of sales relative to revenues as they have dropped substantially since 2006 where the figure was 50. 19%. This could be attributed to the acquisition of a new subsidiary. Therefore, it is anticipated that, in time, better use of the cost of sales will be made and the gross profit margin will recover to a figure closer to 50%.

A final ratio of importance is that of the return on equity. As CWL relies heavily on the shareholders' equity, it is of considerable importance whether or not the shareholders are receiving a good return on their investment. In its broadest terms, the return on equity ratio shows how much return the company is generating in return for every pound that is put into the company. As a general rule, the higher the return on equity ratio, the better the company is doing, although it should be noted that some companies that require little in the way of financial investment such as consulting firms will almost always have a better return on equity ratio than manufacturing firms such as CWL (Costales & Szurovy, 1994) ^[7] .

Once again, in studying the return of equity in relation to CWL, a downward trend between 2006 and 2007 can be seen. This is almost entirely due to the new acquisitions. Therefore, the direct investment in the consolidated company is considerably higher; yet, there has been insufficient time to allow this cash injection to be suitably used to generate increased returns. In a similar way to the gross profit margin, it would be expected that this figure would return to the 2006 figure rapidly and would in the long term be an improvement on the 2006 figures.

It should be noted that when looking at these ratios the consolidated accounts have been used. There was a large acquisition made during the year within the group and this has had an impact on the ratios, during 2007. The overall health of the company in terms of liquidity and profitability is good and the slight apparent wobble in the figures will be reversed in the years to come due to the increasing investments being put into the ongoing expansion of the company.

The calculations and details of the ratios referred to above are contained in Appendix 2.

Appendix 1 Direct Cash Flow

Cash flows from operating activities

Cash receipts from customers 2, 336, 967

Cash paid to suppliers and employees (1, 496, 917)

Cash generated from operations (sum) 840, 050

Interest paid (8, 615)

Income taxes paid (52, 188)

Net cash flows from operating activities 779, 247

Cash flows from investing activities

Proceeds from the sale of equipment/assets (60, 247)

Interest received 3, 336

Acquisition of subsidiaries (88, 209)

Net cash flows from investing activities (145, 120)

Cash flows from financing activities

Issue of ordinary share capital 202, 500

Costs of issue (13, 750)

Investment from minority interests 48, 360

Interest paid (8, 615)

Proceeds from bank borrowings 138, 172

Net cash flows from financing activities 366, 667

Appendix 2 – Ratios Relating to CWL

Ratio	Calculation	Figures
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Current ratio 2007	Current assets / current liabilities	2, 284, 972 / 1, 199, 264
Current ratio 2006	Current assets / current liabilities	1, 187, 951 / 684, 896
Quick Ratio 2007	Current assets (cash equivalents) / Current liabilities	609, 391 / 1, 199, 264
Quick Ratio 2006	Current assets (cash equivalents) / Current liabilities	262, 080 / 684, 896
Gross Profit Margin 2007	(Revenue – Cost of sales) / Revenue	(2, 336, 967 -1, 496, 917) / 2, 336, 967
Gross Profit Margin 2006	(Revenue – Cost of sales) / Revenue	(1, 064, 479 - 530, 234) / 1 064, 479
Return on Equity 2007	Net income / total equity	266, 372 / 3, 148, 576
Return on Equity 2006	Net income / total equity	155, 506 / 1, 133, 966

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Footnotes

[1] Weetman, Pauline, Financial Accounting: An Introduction, Pearson Education, 2006

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